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No. 86-1006

In the Supreme Court of the United States

OCTOBER TERM, 1986

MARATHON OIL COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE FEDERAL RESPONDENTS IN OPPOSITION

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QUESTION PRESENTED

Whether, under a longstanding regulation and federal mineral lease provisions that require royalties to be paid on no less than the "gross proceeds" accruing to a lessee from the sale of natural gas production from federal leases, the Secretary of the Interior may value certain gas, which the lessee produces from federal leases and sells in Japan as liquefied natural gas, on the basis of the landed sales price that petitioner receives in Japan, less allowable costs and deductions for liquefaction and transportation (including return on investment).

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 2a-17a) is reported at 807 F.2d 759. The opinion of the district court (Pet. App. 22a-53a) is reported at 604 F. Supp. 1375.

JURISDICTION

The judgment of the court of appeals was entered on July 24, 1986 (Pet. App. 2a). A petition for rehearing, although not timely filed, was ordered filed by the court of appeals (see Pet. App. 79a) and was denied on January 22, 1987. On October 3, 1986, Justice O'Connor extended the time for filing a petition for a writ of certiorari to and including December 21, 1986. The petition was filed on December 19, 1986. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. The Mineral Leasing Act of 1920, 30 U.S.C. 181 *et seq.* ("the Act"), authorizes the Secretary of the Interior, among other things, to lease public domain lands for oil and gas production. Section 17(c) of the Act, 30 U.S.C. 226(c), provides that "[s]uch leases shall be conditioned upon the payment by the lessee of a royalty of 12½ per centum in amount or value of the production removed or sold from the lease."

The Secretary is authorized by Section 32 of the Act, 30 U.S.C. 189, "to prescribe necessary and proper rules and regulations and to do any and all things necessary to carry out and accomplish the purposes of" the Act. Pursuant to this authority, the Secretary issued the following regulation in 1942 (7 Fed. Reg. 4132, 4137 (emphasis added)):

> § 221.47 *Value basis for computing royalties.* The value of production, for the purpose of computing royalty shall be the estimated reasonable value of the product as determined by the supervisor, due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices and to other relevant matters. *Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof* or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of like-quality oil, gas, or other products pro-

> duced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value.

This regulation has been in force without substantive change ever since, and is now codified at 30 C.F.R. 206.103.

2. Since the 1950s, petitioner has owned working interests in seven federal oil and gas leases within the Kenai Unit in Alaska.[1] Among other things, the leases expressly require the lessee to pay a royalty computed in accordance with the Oil and Gas Operating Regulations, including what is now 30 C.F.R. 206.103. The leases further state that the lessee has "expressly agreed that the Secretary of the Interior may establish reasonable minimum values for purposes of computing royalty on * * * gas" removed or sold from the leased lands. The statute, regulations, and lease terms thus grant the Secretary the authority to determine reasonable value for royalty purposes. See C.A. Excerpts of Record Exh. A; *California Co.* v. *Udall*, 296 F.2d 384 (D.C. Cir. 1961).

Petitioner transports a portion of its share of the gas produced from the federal leases to a liquefied natural gas (LNG) plant at Nikiski, Alaska. The gas is then cooled to a liquid state, loaded on petitioner's tanker vessels, and shipped to Japan, where it is delivered and sold to Japanese public utility customers. Thus, the first sale of the gas does not occur until it is delivered in Japan. Pet. App. 3a.

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[1] Because of conveyances of certain lands to Cook Inlet Region, Inc. (CIRI), an Alaska Native Regional Corporation established pursuant to the Alaska Native Claims Settlement Act (ANCSA), 43 U.S.C. 1601 *et seq.*, CIRI is entitled to approximately 65 percent of the royalties from oil and gas produced on the leases, with the remaining 35 percent going to the United States. The federal government has retained administration of the leases pursuant to Section 14(g) of ANCSA, 43 U.S.C. 1613(g).

Since the mid-1970s, petitioner and the government have been involved in a dispute concerning the royalty value of the Kenai Unit gas that petitioner sells in Japan. First the United States Geological Survey (USGS), and now its successor agency the Minerals Management Service (MMS), Department of the Interior, have maintained that, under 30 C.F.R. 206.103, the royalty value cannot be less than petitioner's "gross proceeds," *i.e.*, the sale price that petitioner receives on the initial sale of the gas in Japan, less allowances for liquefaction and transportation (including a return on investment). Petitioner, however, has asserted that the sale price that it obtains in Japan has no relevance to royalty value and claims that the royalty value of the LNG volumes must be determined by reference to the prices paid by local Alaskan gas customers for other gas produced from the federal leases. Pet. App. 24a.

In an effort to resolve this dispute, petitioner and the USGS agreed in 1981 to a method of determining royalty value based on petitioner's sale price for LNG in Japan, reduced by a fixed percentage (and subject to various adjustments). This agreement, however, was subject to termination in the event of changed market conditions or other factors. Pet. App. 4a.

In fact, market conditions changed shortly after the agreement was entered. In 1983, MMS notified petitioner that it intended to redetermine prospectively the reasonable royalty value for the Kenai Unit gas sold in Japan (Pet. App. 71a). Under that revision, petitioner would be required to compute its gross proceeds, for royalty calculation purposes, based on the sales price in Japan less its actual costs for liquefaction and transportation, including a return on its investment (*id.* at 64a-70a).[2]

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[2] The procedure proposed by MMS described the deductible element "Return on Investment" as follows (Pet. App. 70a):

> The lessee shall present to MMS a proposed reasonable rate of

Following a public hearing, MMS determined that the royalty value should be computed in the manner previously proposed to petitioner. Accordingly, on July 8, 1983, MMS directed petitioner to calculate royalty values according to the gross proceeds methodology set forth in its prior letter to petitioner (*id.* at 61a-63a). That methodology, which takes as its starting point the actual sales price received by petitioner in Japan and then "works backwards" by allowing various deductions to arrive at the value of the gas at the leasehold, has been referred to in this proceeding as a "net-back" formula.

3. Petitioner did not comply with the order of July 8, 1983, or supplementary MMS orders.[3] Rather, in 1983, petitioner initiated this action against the United States and other federal parties, the State of Alaska and a state officer,[4] and CIRI. Petitioner sought judicial review of

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return for this type of operation in the Alaska region at the time covered by this project. This proposal shall identify all components such as risk, cost of capital, etc., that are incorporated in this rate. If the lessee is unable to provide convincing evidence that their proposed rate of return is reasonable, MMS will fix a value and advise Marathon of the rate of return to be used.

[3] Even before MMS issued its order of July 8, 1983, petitioner had stopped calculating royalties on the basis of the compromise methodology that had been in effect since 1981. Instead, petitioner began to compute and pay royalties on the gas sold in Japan based on a value of production equal to the prevailing sales price under a 1975 gas sales agreement amendment with a local Alaskan customer, thereby unilaterally rolling back its royalty payments by almost two-thirds. In October 1983 and June 1984, MMS issued further orders directing petitioner to pay certain amounts of underpaid royalties and to comply with MMS's previous orders. Petitioner did not comply with any of the orders. Pet. App. 54a-60a.

[4] Under Section 35 of the Mineral Leasing Act, 30 U.S.C. 191, the State of Alaska is entitled to 90 percent of the royalties received by the United States from the federal leases.

MMS's orders concerning petitioner's royalty obligations and requested a judgment declaring that it "may compute royalties on the natural gas produced from the Leases which is supplied to the LNG Plant on the basis of the highest field market price paid under arms-length sales of natural gas in the Kenai Field to Alaska purchasers." Second Amended Complaint at 23.

The district court entered an opinion and order in favor of the defendants (Pet. App. 22a-53a). The district court, stating that its primary task in this case was to ascertain whether MMS's orders constituted a reasonable interpretation of the Mineral Leasing Act and the implementing regulations (*id.* at 30a), held, among other things, that "the MMS orders directing Marathon to use the net back method fall within the agency's authority under the statutes and regulations" and are also consistent with the terms of the leases (*id.* at 45a). In particular, the court "agree[d] with [petitioner's] basic premise" that royalties should be based on the value of production *at the lease*, but held that the net-back method was an appropriate method for determining that value (*id.* at 43a). Accordingly, the court granted summary judgment to the United States and dismissed petitioner's claims against the United States (*id.* at 18a-21a). The court directed petitioner to pay royalties in accordance with MMS's orders and retained jurisdiction to conduct accounting proceedings (*ibid.*).

The court of appeals affirmed (Pet. App. 2a-17a). The court of appeals upheld the district court's ruling concerning the validity of MMS's net-back valuation formula for the reasons stated in the district court's opinion (*id.* at 10a-11a). The court also rejected various other arguments that had not been explicitly addressed in the district court's opinion (*id.* at 11a-17a).

ARGUMENT

The decision of the court of appeals is correct, conflicts with no decision of this Court or any other court of appeals, and presents no issue of general importance warranting review by this Court. Accordingly, the petition should be denied.

1. Petitioner's primary argument (Pet. 7-13) is that the Mineral Leasing Act itself somehow precludes use of the net-back methodology, and that the courts below therefore erred in accepting the agency's interpretation of the Act even if it was otherwise reasonable. Petitioner's argument proceeds, in its entirety, from Congress's use of the word "royalty" in Section 17(c) of the Act, which petitioner says means a percentage of the actual production or its value at the lease (Pet. 10). The simple answer is that, as the district court noted (Pet. App. 43a), the net-back methodology is a means of determining value at the lease. There is no evidence whatsoever that Congress considered the question presented in this case—how to value production at the lease when the first sale takes place elsewhere after further processing and transportation—and determined that a net-back methodology was inappropriate. In these circumstances, and in light of the broad delegation of authority in Section 32 of the Act, the courts below appropriately deferred to the agency's reasonable interpretation.[5]

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[5] There is no substance to petitioner's contention that the courts below erred by not "*explicitly* find[ing], as a matter of law, that the statute and legislative history are ambiguous on the disputed issue" (Pet. 9 (emphasis added)). Petitioner does not point to anything in the statute or legislative history that unambiguously resolves the question presented in this case. In the absence of any colorable claim along those lines, petitioner's argument amounts to nothing more than a suggestion that courts err when they draw correct conclusions about statutory language and legislative history implicitly rather than explicitly. This Court's decisions do not mandate the formalistic approach for which petitioner contends.

Petitioner asserts, in substance, that the Mineral Leasing Act states that the government may collect a "royalty" on gas production from federal lands leased under the Act, that here the Secretary has attempted to assess a "net-profits interest" instead of a "royalty," and that the courts below erred by deferring to the Secretary's interpretation of the Act as allowing him to impose a "net-profits interest" instead of a "royalty." Pet. 11-12. Petitioner's position is without merit.

As we have shown (page 3, *supra*), the leases in question expressly provide that they are subject to MMS's regulations and that petitioner agrees that the Secretary of the Interior "may establish reasonable minimum values for the purposes of computing royalty on * * * gas" removed or sold from the leases. The applicable regulation, which has been in force for 45 years and at all times since the leases were entered, provides that "[u]nder no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof." 7 Fed. Reg. 4137 (1942). Hence, under the terms of the regulation and leases, the royalty value may be no less than the lessee's gross proceeds, regardless of what may be the generally prevailing market price in that area. A provision obligating the lessee to pay a share of gross proceeds is a "royalty" interest. R. Hemingway, *The Law of Oil and Gas* § 7.4, at 316, 320-321 (1971 & Supp. 1979).

If petitioner sold its production at the leasehold, its "gross proceeds" would be simply the amount that it received from the purchaser. Petitioner, however, sells its production for the first time on delivery in Japan rather than at the leasehold. Accordingly, as the district court correctly observed (Pet. App. 40a-41a, 45a), it was necessary for MMS to devise a method for calculating the gross proceeds value of the production at the leasehold. The methodology that MMS has adopted to make this cal-

culation starts with the actual sale price that petitioner receives in Japan and then makes allowances for costs of transportation and liquefaction (including a return on investment) to arrive at the gross proceeds value of the gas at the leasehold.

As the courts below noted (Pet. App. 11a, 40a), such a "net-back" method of ascertaining royalty value is well established and accepted in the industry. "Royalty payable upon the 'proceeds' of the sale of gas, will be computed on the basis of aggregate gross receipts from all products, less the costs of marketing and transportation. The presence of actual sales in the field is immaterial." R. Hemingway, *supra,* § 7.4, at 316. As the Tenth Circuit has observed:

> The work-back valuation is well recognized in the production and early processing of natural gas. It is commonly used, according to this record, in placing a value on feed stock for gasoline plants and related processing. There is nothing unusual about the method, it is subject to proof, and can be just as accurate as any other method, but it is more difficult to apply.

Ashland Oil, Inc. v. *Phillips Petroleum Company,* 554 F.2d 381, 387 (1975), cert. denied, 434 U.S. 921 (1977); see also *Continental Oil Co.* v. *United States,* 184 F.2d 802, 820-821 (9th Cir. 1950).

Petitioner inaccurately represents (Pet. 5) that the Secretary conceded in the court of appeals that the government was attempting to levy a "profit-sharing interest" rather than a "royalty." At no point did the government ever state or imply that it was seeking to collect other than, or more than, a "royalty" interest. Of course, whenever a lessee sells its production at a price greater than the commonly prevailing local market price, the lessor, under a "gross proceeds minimum" lease (as contrasted to a pure market value lease), will "share" in such "entrepreneurial profits" in the sense that the lessor has a stake in the

lessee's receipts. That result, however, does not transform a gross proceeds provision from a royalty interest into a net profit share interest.[6]

2. Petitioner lists a number of factors that courts consider in determining the amount of deference owed to an agency's interpretation of a statute it is charged with administering (Pet. 14-17). For the most part, we agree with petitioner that the factors it lists are appropriate.[7] Those factors support the deference given to MMS in this case.

Certainly the amount of deference given an agency is greatest when the delegation of authority is broad (Pet.

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[6] As petitioner points out (Pet. 11), in the mining industry a "royalty" is a cost-free share of production whereas a "net-profits interest" is a share of profits from production after costs have been deducted. Here, the leases at issue require that production be valued for royalty purposes at no less than the gross proceeds accruing to the lessee. Under these leases, the lessee's costs of production at the leasehold are irrelevant and the amounts that the lessee must pay the government are not tied to the lessee's profits. Indeed, the lessee would remain obligated to pay a 12½ percent royalty on its gross proceeds even if it were making no net profit whatsoever. And, as we have pointed out (pages 4-5, *supra*), the royalty valuation methodology at issue specifically entitles the petitioner to deduct such rate of return on its investment in its liquefaction and transportation facilities (including risk) as it may show to be reasonable.

[7] Petitioner, however, incorrectly claims (Pet. 17) that MMS's interpretation of the Mineral Leasing Act is entitled to less deference in this case because the government has a "pecuniary interest" in the amount of royalties to be collected. The cases on which petitioner relies are due process cases indicating that a decisionmaker should not have a *personal* financial stake in the outcome of the proceeding and are obviously inapposite. Indeed, if petitioner's argument were correct, the Internal Revenue Service, which is always "a collection agency for the Treasury" (*ibid.*), would not be entitled to deference in its interpretation of the Internal Revenue Code, yet this Court has not hesitated to give "considerable deference" to the IRS's interpretation of the Code. *United States* v. *National Bank of Commerce*, 472 U.S. 713, 730 (1985).

14-15). In this case, Section 32 of the Act constitutes a very broad delegation of authority to do that which is "necessary and proper."

The agency's expertise is also an important factor (Pet. 15). Although petitioner suggests otherwise, we do not think that it can be seriously disputed that MMS and the Department of the Interior have expertise in matters of oil and gas law in general and interpretation of the Mineral Leasing Act and leases thereunder in particular. See *Udall* v. *Tallman,* 380 U.S. 1, 16 (1965) (deferring to interpretation of Mineral Leasing Act by Secretary of the Interior).[8]

Finally, the "timing and consistency" (Pet. 15) of MMS's interpretation of the statute, and other factors petitioner lists (Pet. 15-17), are also consistent with the deference granted by the courts below. The "gross proceeds" provision of 30 C.F.R. 206.103, which virtually requires use of the net-back methodology in this case, has been part of the agency's consistent interpretation of the Act for 45 years. In addition, the court of appeals, referring to its 35-year-old decision upholding a closely analogous ruling by the Secretary of the Interior in a Mineral Leasing Act royalty dispute, stated that "[t]his is not the first time we have concluded that it is not unreasonable for the Secretary to use a net back or net realization formula to compute the value of production for royalty purposes" (Pet. App. 11a (citing *Continental Oil Co.* v. *United States, supra*)). Similarly, the district court, whose reasoning was adopted by the court of appeals (Pet. App. 11a), rejected petitioner's contentions that the net-back formula at issue was inconsistent with

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[8] Petitioner remarkably suggests that *Chevron U.S.A. Inc.* v. *NRDC,* 467 U.S. 837 (1984), "implicitly rejected the approach taken in some earlier cases" (Pet. 8) including *Udall* v. *Tallman.* Just the opposite is true. *Chevron* reiterated "well-settled principles" (467 U.S. at 845) culled from such cases as *Udall* v. *Tallman,* which was cited in 467 U.S. at 843 n.11. See, *e.g., United States* v. *Riverside Bayview Homes,* No. 84-701 (Dec. 4, 1985), slip op. 9-10.

previous Interior practices (*id.* at 36a-39a, 44a), found the agency's methodology to be "a reasonable method for establishing a basis for computing royalties" (*id.* at 44a), and concluded that "the MMS orders directing Marathon to use the net back method fall within the agency's authority under the statutes and regulations" (*id.* at 45a).

In short, the courts below did not simply "rubber stamp" the Secretary's position but, after examination of the statute, the applicable regulation, and the leases themselves, determined that the agency had reached a reasonable interpretation entitled to deference in the circumstances of this case. That conclusion was correct.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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